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LAW JOURNAL NEWSLETTERS

LJN'S
Equipment Leasing Newsletter ®

Volume 26, Number 9 • October 2007

Issues in Private Label Lease Transaction Workouts

By Anthony L. Lamm

Issues inherent to private label lease transactions present an additional layer of complexity to the already challenging area of equipment leasing. The fact that the identity of the real owner of a lease has not been disclosed to the lessee, and that the owner is usually relying on third parties to service and collect the lease, introduces an additional element of risk to the transaction that may surpass the credit risk present in any transaction. As is often the case, careful drafting of the underlying documents dramatically enhances the likelihood of the successful resolution of a defaulted lease. Thoughtful documentation of the transaction from the outset, and conscientious monitoring of both the lessee and the assignor or entity servicing the lease, if they are distinct, is critical to successful portfolio management. This article highlights some of the issues that cause complexity in the private label lease transaction and suggests drafting ideas and litigation strategies that will minimize the additional pitfalls that can arise out of the complexity.

General Definition

A private label lease transaction may be generally defined as a transaction where the lease has been assigned to and is owned by one other than the lessor named in the lease, and which is being serviced by and in the name of the lessor or a third-party servicer on behalf of the assignee, or by the assignee in the name of the original lessor. Until notified otherwise, the lessee is not aware of the lessor's assignment of either ownership of the transaction or its servicing rights.

Private label lease transactions arise in a number of circumstances to address a number of situations. For example, an equipment vendor may wish to form a relationship with a leasing company willing to accept leases naming the vendor as lessor in order to give the vendor's customers the impression that the vendor is a full-service, one-stop source for all of the customers' equipment needs, including finance. Or, a leasing company that has invested heavily in the establishment of its

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What's New in Leasing Law

By Robert W. Ihne

Ability to Collect Rentals

AT Publishing, Inc. v. OFC Capital, 2007 WL 1725603 (U.S.Dist.Ct. D.Alaska June 13, 2007): In a case involving mostly issues of procedure and evidence concerning a lease of equipment alleged by the lessee to be non-conforming, the court holds that the law governing the obligations of the parties to an Article 2A finance lease is clear that the lessor has no obligation to provide conforming equipment, which obligation belongs instead to the equipment supplier.

Key Equipment Finance, Inc. v. South Shore Imaging, Inc., 835 N.Y.S.2d 268 (App.Div. 2007): This court overturns a lower court's holding that a lease of imaging equipment was unenforceable because its print was less than eight points in depth — in violation of a New York statute. The appellate court notes that the statute applies by its terms only to printed contracts involving either: 1) consumer transactions for personal, family, or household purposes; or 2) residential leases, whereas this equipment was medical equipment being used by a corporate lessee for business purposes.

Rafter Seven Ranches LP v. C.H. Brown Company (In re Rafter Seven Ranches LP), 362 B.R. 25 (Bankr.App.Panel 10th Cir. 2007): Interesting case involving the

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brand will wish to have that brand appear in both the lease documentation and all servicing correspondence in order to project its presence into the marketplace as a credible leasing organization. The leasing company may retain servicing rights to the lease and service it in its name in order to continue close lessee relationships, gaining the inside track on future customer lease business, or the leasing company may transfer the servicing rights and obligations to the assignee of the transaction or a third-party servicing company to reduce the costs of its operations by shedding the servicing responsibilities, while continuing to appear to the lessee as the lessor.

Required Documents

The documents that underlie the multi-party private label lease transaction include a private label lease program agreement and an agreed-upon form of lease document showing the lease originator as lessor and containing both usual and customary terms as well as any terms relevant to the relationship between the nominal lessor and the unnamed assignee or servicer, such as maintenance obligations that could affect the servicer or assignee. Other typical documents include a schedule of assignment whereby the lease is assigned by the originator/lessor to the lender, as well as a standard form of delivery and acceptance certificate and other documents needed to properly reflect the status of the various parties, such as purchase options, stipulated casualty loss schedules, etc.

The private label lease program agreement sets forth the business and legal points of the transaction between the lease originator/lessor (assignor) and the lender/lease purchaser (assignee). As this document is prepared, it is important to remember that the assignee is assuming not only the credit risk presented by the lessee, but also the risk of possible default and insolvency by the assignor. Thus, the preliminary question of which party will hold the original lease documents must be addressed. If the assignor will continue to service the lease, it will want to retain the original documents for itself in order to aid in the servicing of the lease. On the other hand, and very importantly, a security interest in chattel paper and documents of title may be perfected by the secured party's physical possession of the documents, and physical possession of the lease documents will help to prevent fraud and potential disputes with other creditors of the assignor. In the event that the assignee is not able to take physical possession of the documents, the program agreement must be emphatically clear that the assignor, as servicer, is a mere conduit for payments and that all payments and documents are held "in trust" for the assignee. Further, each assigned transaction must be accompanied by a UCC-3 statement showing assignment of the security interest by assignor to assignee and a power of attorney authorizing assignee to execute all documents on behalf of assignor deemed necessary by assignee to perfect its interest in the lease and the equipment (although the power of attorney is often contained in the program agreement.)

The program agreement must also address two other issues. First, the assignor must make representations and warranties regarding the accuracy and completeness of the information supplied by assignor to assignee for its review in determining whether to purchase the lease: that there are no unusual conditions to the transaction and that the transaction is in all respects legal and enforceable. Second, the program agreement must circumscribe the servicing component, which may be taken either by the assignor or a third-party servicer without the prior consent of the assignee. Some examples here might

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Equipment Leasing Newsletter®

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LJN's Equipment Leasing Newsletter® (ISSN 9733-4304) is published by Law Journal Newsletters, a division of ALM.

Telephone: (800) 999-1916
Editorial e-mail: jgromer@alm.com
Circulation e-mail: almcirc@alm.com
Reprints e-mail: lmelesio@alm.com

LJN's Equipment Leasing Newsletter P0000-235
Periodicals Postage Pending at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
345 Park Avenue South, New York, NY 10160

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, Pa 19103
www.ljnonline.com

An incisivemedia company
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include: prohibitions on the waiver or exchange of payments, release of collateral or equipment, waiver of defenses, or the release of credit parties (the lessee, co-lessee, or guarantors). These limits are important not only to protect the assignee's economic expectations regarding the transaction, but also to allow the assignee a defense for the *ultra vires* acts of the assignor or servicer giving rise to a lawsuit or counterclaim by a defaulted lessee.

Other terms to be included in the program agreement to reduce assignor/servicer default risk may include the assignee's ability to terminate the servicer early, requiring quick remittance of amounts collected with full written backup, or even a lockbox, where the servicer bills (but does not collect) lessee remittances. The assignee may wish to monitor the assignor's compliance with all of the representations, warranties, and covenants by reviewing credit reports and making "blind inquiries" to lessees regarding the assignor and its servicing of the lease. In the event of any breach of a warranty, representation, or covenant, the assignee should have the right to "put" the lease back to the assignor at a specified price.

What to Do in the Event of Default

There may come a time, however, where the lessee has defaulted and forced collection of the lease is necessary, or the assignor has defaulted and the assignee wishes to step in and enforce collection following lease defaults. The program agreement will address when the assignee is allowed to emerge from behind the private label, known as "breaking private label," and important issues of protection of intellectual property (assignor's investment and property rights in its name), and litigation requirements and strategies must be weighed. Resignation of the assignor as servicer will usually cause the breaking of private label. Once again, the program agreement between assignor and assignee will list those events that either allow or require the assignee to break private label and notify the lessee of its identity as owner of the lease.

The timing of the delivery of the assignee's notice of assignment is of particular importance. Until delivery of the "doomsday" notice, payments made by the lessee to the assignor or concessions or other waivers made by the assignor to the lessee will be binding on the assignee. *See,* 9 UCC §406(a), *Frankford Trust Company v. Stainless Steel Services, Inc.* 327 Pa. Super. 159, 475 A.2d 147 (Pa. Super. Ct. 1984). In *Frankford Trust*, the court noted that "generally, an assignee remains at the peril of the subsequent dealings between the original parties until adequate notice of the assignment is given to the obligor." The notice to the lessee should not only include identity of the assignee, but also directions that all future payments and inquiries be directed to the assignee.

Should litigation become necessary to enforce the rights of the assignee under the lease, federal and state rules of civil procedure require that the action be brought in the name of the real party in interest under the lease. For instance, Federal Rule of Civil Procedure 17 provides that "every action shall be prosecuted in the name of the real party in interest." A lease enforcement action brought in the name of the original lessor, where the transaction has been assigned, is vulnerable to a challenge by the defaulting lessee under Rule 17 that the action should be dismissed as having not been brought in the name of the real party in interest. To obviate this attack, not only should the "doomsday" notice be delivered prior to commencing the litigation, but also a copy of the notice and the assignment by the original lessor to the assignee/plaintiff should be attached as exhibits to the complaint. Attachment of the "doomsday notice," as well as allegations in the complaint explaining the relationship between assignor and assignee, will also help in defeating motions under Federal Rule of Civil Procedure 19 and similar state rules requesting dismissal of an action for failure to join all necessary parties.

On the other hand, if the jurisdiction in which the action is brought allows one party (assignee) to bring the action in the name of another party (assignor), a counterclaim brought by the lessee against the assignor may give rise to disputes between assignor and assignee as to defense strategies and indemnification. The program agreement should specify which party will control the litigation, usually the assignee, and who will bear the costs for the litigation, especially if costs are incurred

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IN THE MARKETPLACE

Thompson Coburn LLP of St. Louis, MO, and **FagelHaber LLC** of Chicago have announced a merger. The combined firm has more than 330 attorneys with offices in St. Louis and Chicago — two of the region's major business centers — and additional offices in Washington, DC, and southern Illinois. The combined firm's Chicago office will initially be known as Thompson Coburn Fagel Haber, enabling it to leverage the name recognition that FagelHaber has developed in the Chicago legal and business communities over the past 45 years. Thompson Coburn LLP is a full-service law firm with offices in Chicago, St. Louis, southern Illinois and Washington, DC. The firm regularly represents lenders and equipment lessors in the inland and offshore maritime industries, as well as ship owners, charterers, investment bankers, and related parties in all types of project and equipment finance transactions, principally relating to ships, barges, and containers.

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defending against claims arising out of the assignor's misfeasance in the servicing of the lease.

The best defense for the assignee of a private label lease transaction is to be a holder in due course of the assigned transaction. A holder in due course is an assignee that takes an assignment: 1) for value; 2) in good faith; 3) without notice of a claim of a property or possessory right to the property assigned; and 4) without notice of a defense or claim in recoupment of the type which may be asserted against a plaintiff seeking to enforce a negotiable instrument. *See,* 9 UCC §403(b). A holder in due course takes the assignment free and clear of any defenses that the lessee may have had against the original lessor. Because courts, from time to time, have denied holder-in-due-course status to assignees where the relationship between assignor and assignee was too close, it is important that both the program agreement as well as the course of dealing between the parties remain at arm's length. *See,* Vasquez *v. Superior Court of San Joaquin County*, 4 Cal. 3d 800, 484 P. 2d 964 (Cal. 1971), where the court held that "since the assignee of a contract and note advanced money to the seller with the understanding that these instruments would be assigned to it, supplied the contract forms to the seller, and actively participated in the transaction from its inception, it could not claim holder-in-due-course status." 484 P.2d, at 979. Similar considerations may also apply in transactions involving finance leases, where the hell or high water protections afforded the lessor/assignee will be placed in jeopardy if it is found that the assignor participated too closely in the formation of the transaction. *See,* 2A UCC §§103(g)(1) and 407(1).

Another issue that can be successfully addressed by careful drafting of the lease documents is that of forum selection. Because so many lease transactions are assigned, and most assignees would prefer to litigate in the courts of the state in which they are domiciled, lease agreements contain a "floating forum selection provision." The lessee, in essence, agrees to submit itself to the jurisdiction of the court where the assignee legally resides, even if that court is far distant from the legal home of the lessee. While these floating forum selection provisions have generally been upheld, if it can be anticipated to whom leases to be generated and assigned under the program agreement will be assigned, the forum selection clause can be drafted to provide that the lessee submits itself specifically to the jurisdiction of the courts in the legal home of the anticipated assignee, without revealing that the lease transaction is to be assigned or the name of the assignee.

Conclusion

Private label lease transactions are widely used in the leasing industry and provide benefits for both the originator and assignee of the private label lease, including liquidity of the assignor and introduction of the assignee/lender to a new pool of lending transactions to which it might not otherwise have gained access. The benefits, however, must be weighed against the possible harm that arises out of giving some or all of the control over the transaction to the originating lessor. Carefully drafted program agreements and lease documents will specify the roles of the assignor and assignee, the actions that may be taken by the assignor in its servicing of the lease transaction (or conversely, the limitations on the actions of the assignee in servicing the lease transaction on behalf of the private label assignor), when the assignee may "break private label," and proper allocation of the risks that flow from the decision either to break, or not to break, private label.

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